RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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July 30, 1980 **LETTER 788**

July 17, DJIA 923.98; PTI 1274; A-D ratio –17.06
July 25, DJIA 918.09; PTI 1268; A-D ratio –17.29

LET THE MARKETS TELL US: In investing, nothing speaks louder or with more authority than the trend of the markets.By the same token, in investing and handling money, your most important job is to position yourself on the right side of the right markets.

On July 8 the D-J Transportation Average confirmed the bullish action of the Industrials. On that day the Transports closed at an all-time high (above its previous high of 305.80). From the Dow Theory standpoint, the only remaining upside targets are the 1014.79 Industrial peak of September 21, 1976, and the all-time Industrial high of 1051.50 recorded on January 11, 1973. If Industrials can better the 1973 all-time high, we will have had a primary bull signal of the first magnitude, following an extended and exasperating "consolidation period" lasting seven long years!

The advance-decline ratio is a proxy for ALL the stocks on the NYSE. Lately, the A-D has been doing its part. On July 21 the A-D ratio finally bettered its late-January peak of minus 16.91. To fully confirm the action of Industrials, however, the A-D must now better the August, 1979 peak of minus 15.67.

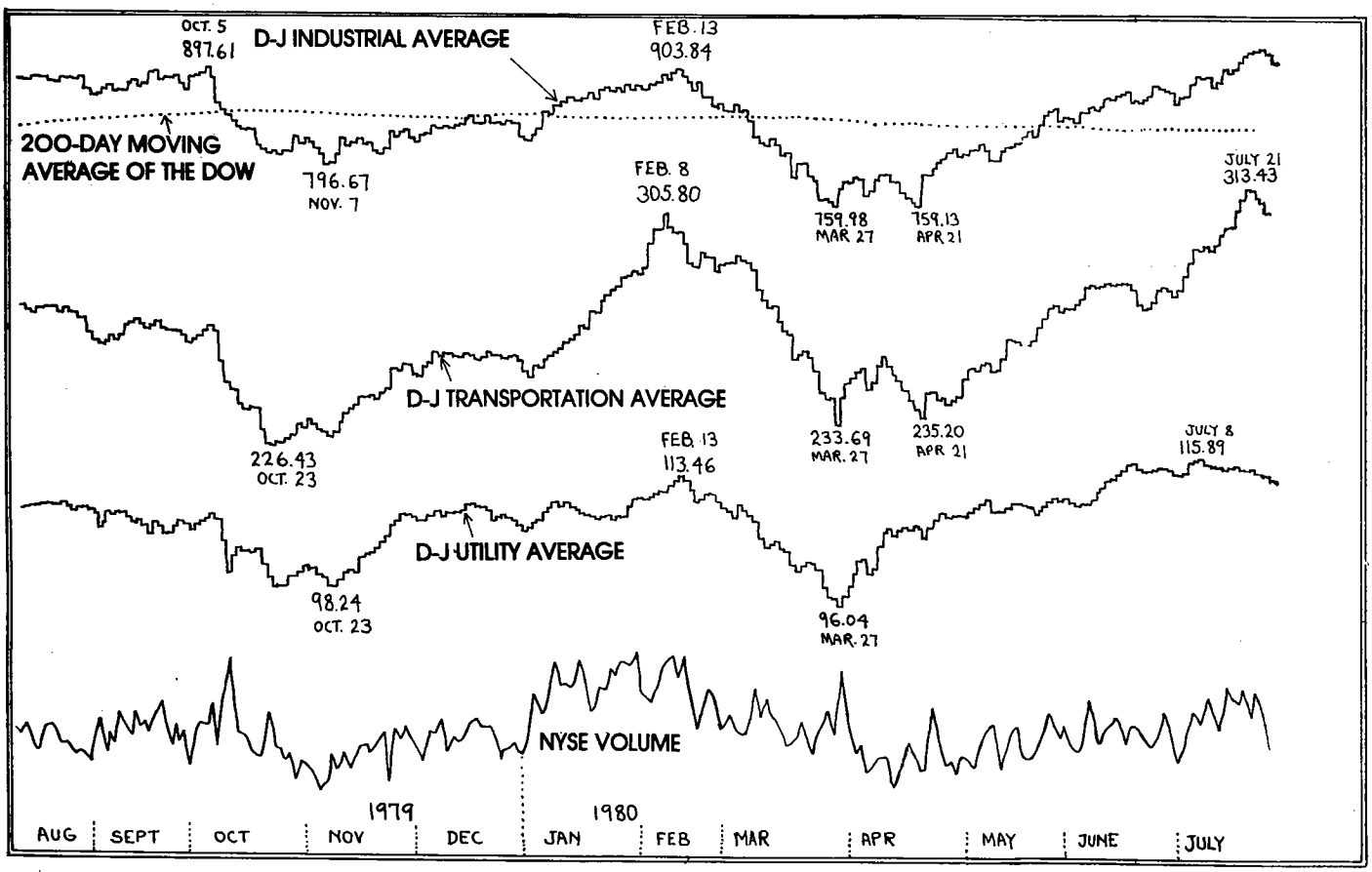
The Primary Trend Index, my proprietary market barometer, has been insistent (since March) in saying that the direction of the market is up. On page 2 I have included the daily chart of the Dow, the PTI and the A-D ratio. The chart is self-explanatory. What we see here is a straight-line rise in the trend of the PTI. This index pushed to its all-time high on June 11, and this event was duly reported in Letter 785 (June 18).

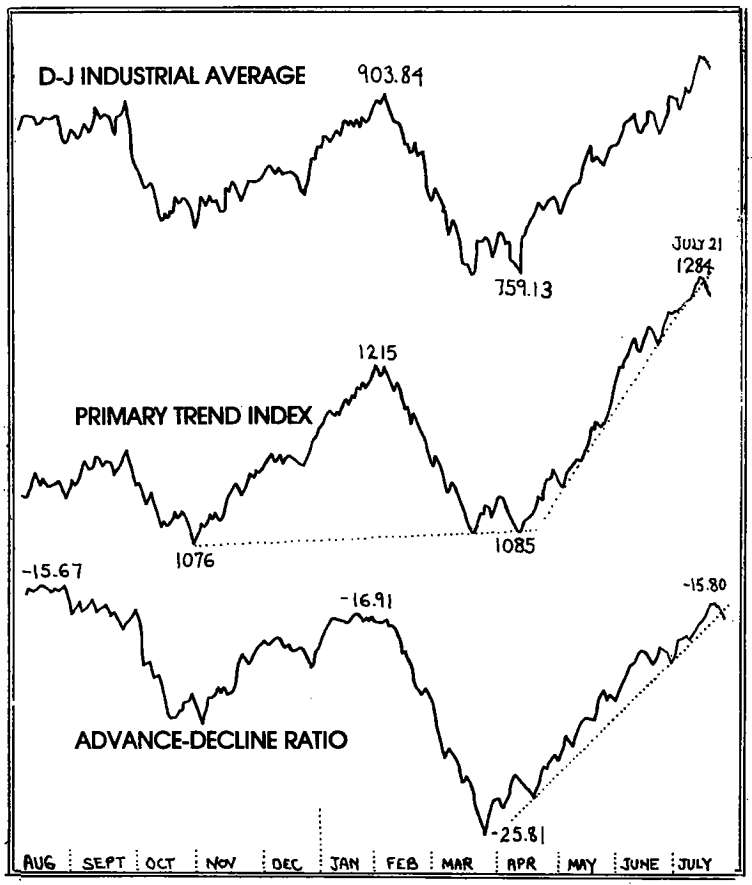
On July 21 the PTI extended its rally to 1284, held there for one more day, and then declined. On July 24 the long ascending trendline from March was finally ruptured. What is the meaning of this first reversal?

As I see it, this is the first suggestion that the PTI could be in the process of turning from up to down. Admittedly, the March-July trendline was rising at a steep (unsustainable) angle, so it was just a matter of time before the PTI broke through the trendline. Nevertheless, the trendline did hold for four months, and now it is broken. One thing can be said–as long as the rising trendline on the PTI remained unbroken, no reaction or important decline was in the cards. With the trendline ruptured, the PTI is saying that a reversal to the downside **could be** in the making.

A second reason for care is that the PTI trendline break came just prior to the August cyclical top that I have been writing about. More on this in a later section.

As far as the moving average study of the PTI is concerned, the three MA's continue in the bullish mode. By this I mean that the 3-week MA is above the 8-week MA, and the 8 in

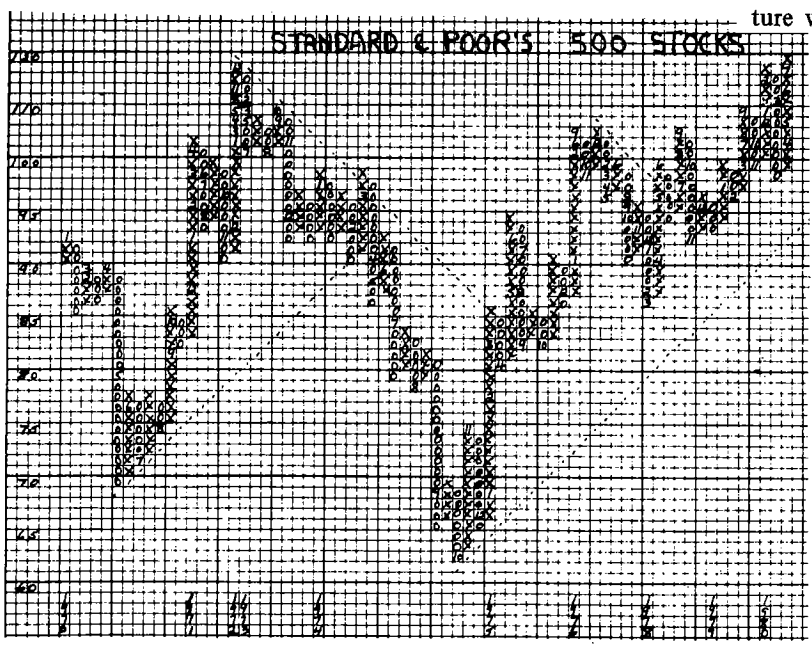


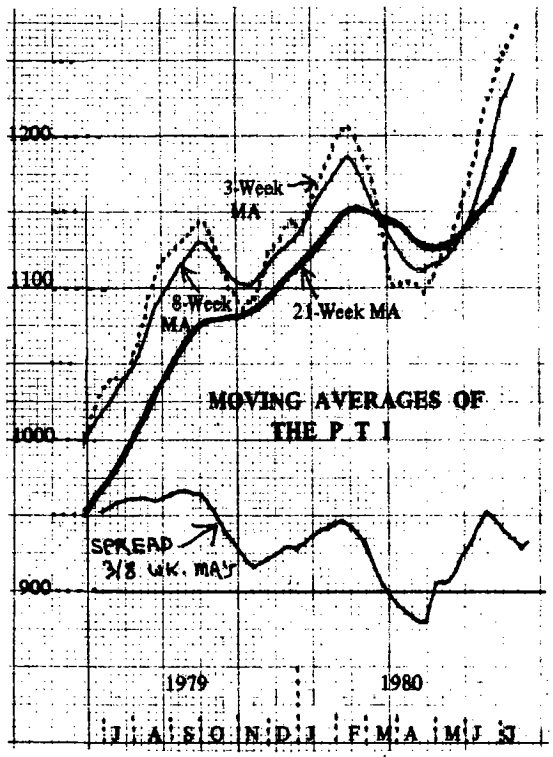


turn is above the 21-week MA. The "sensitivity" device on the MA study is the spread between the 3-week and the 8-week MA. The spread gauges the upward momentum of the MA's, and as you can see, the spread did turn down a few weeks ago. This too is a hint, just a hint, of potential trouble.

TWO STUDIES: There are two studies that have me fascinated at this time. Taken together, they could prove critically important for investors. The first study is pictured on the point & figure chart (courtesy Chartcraft, Larchmont, NY).

Here we see the broad Standard & Poor's Composite of 500 stocks. This widely-followed and representative index has been in





the process of forming a perfectly huge head-and-shoulders bottom. Last week, when the S&P 500 hit the 120 box, this pattern broke out or became bullishly operative.

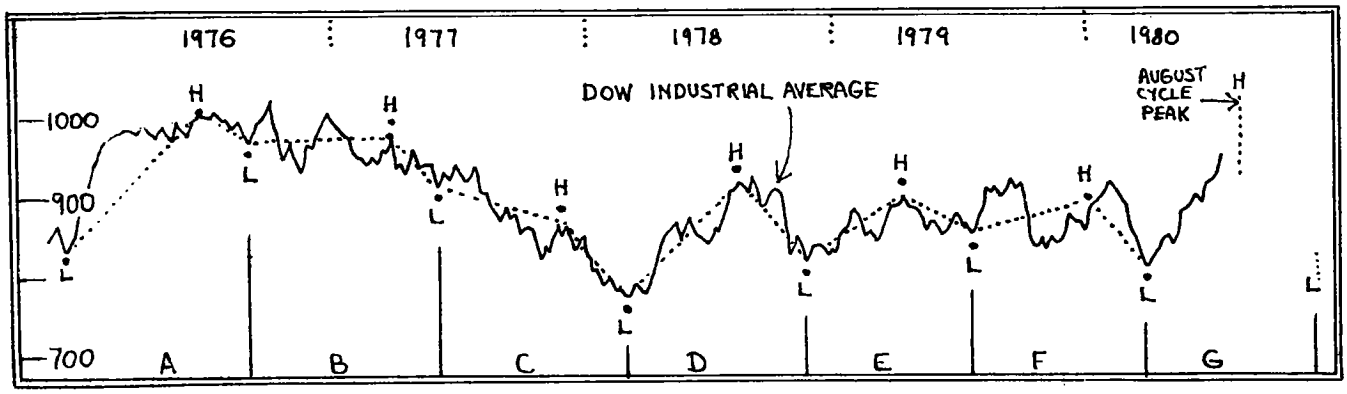
No chart or chart pattern is 100% reliable. If they were, the stock market would be the sure road to riches (which it most certainly is not). But head-and-shoulders patterns tend to be one of the more reliable chart patterns, and we certainly have one here in the 500.

IF this chart fully expresses itself, the move for the stock market could be massive on the upside. The upside count provided by this H&S base pattern could easily take the S&P 500 up 50% or more from this area. It is important to remember, however, that the chart does not say HOW the market is to move higher or how long that rise will take. For that I will fall back on my old adage, "the stock market will do whatever it has to—to drive the largest number of investors 'up the wall'."

From the investors standpoint, that's the long-term bullish picture which Wall Street is now presenting. But there is an intermediate-term consideration which I want to discuss. Back in Letter 781 (April 23) I drew attention to my Fibonacci work with stock market cycles. I wrote that I had been working for some years with a 233-day cycle, a cycle which seems to exert a very important influence on the stock market. In Letter 781 I noted, "If my cycle holds true, the peak of the current up-cycle should occur around mid-August."

As I said, that was written in April, and we are now moving close to the August period. So far, the up-portion or bullish portion of the 233-day cycle has been right on target. It should be remembered, however, that each cycle (see page 3 chart) is made up of two segments, a 144-day bull segment and an 89-day bear segment (144 plus 89 equals 233). The 144-day bull segment of this cycle terminates around mid-August (give or take a few weeks either way).

I include a chart of the Dow Industrials showing the highs and lows of the 233-day cycle and covering the period of



1976 to the present. Since 1976 there have been six full 233-day cycle spans and we are part way through the seventh cycle now. I have lettered each of these cycles (A through G). And you can see that since 1976 there have been only two really powerful cycle periods, span A in early 1976 and span D in the first half of 1978. Span G, the current cycle, looks as though it is at least potentially the third truly strong cycle since 1976.

The cycles do not forecast the extent of any move. But they do present **timing influences and directional influences.** For instance, note the weak bull segment of cycle B. This was indicating that the bear sector would also be very weak, which it was. Note the continuing weak bull segment of cycle C. This was followed by a very weak bearish segment of that same cycle. The F cycle was particularly interesting. Note that the bull segment of the F cycle started out strong, then caved in. The bearish segment of B started out strong (against the cycle influence) but the cycle influence finally took hold and the Dow dropped to the 759 level to complete the bearish segment of the F cycle.

Next, we come to the present or G cycle (March to August). At this point it must be said that the G cycle looks very impressive, very bullish. On July 16 the Industrials pushed above their preceding cycle peak of 903.84 (Feb. 13). Transports confirmed. So far, very good.

What I am most interested to see is how the market acts during its second or bearish segment. This will be a most important and significant test of strength. On July 22 it was announced that the short interest on the NYSE had increased to a record 64 million shares. If the primary trend of the market is up (and it gives every appearance of being bullish) then these 64 million short shares are trapped on the WRONG side of the market. If they have any opportunity of getting out and limiting their losses, I would think that the chance will come during the bearish segment of the current 233-day cycle, which is due to start in the next few weeks or so.

It is this action that I want to study. If there is very little give to the market during the bear-segment of the cycle, if it gives but brudgingly during the period of August to October, then we'll have a "stock market tiger" on our hands. In that case I will probably recommend fully invested positions in the stock market. As a point of interest, note that the market has SOLD OFF during the bearish segment of every cycle since 1976!

So what I want to see is HOW this 233-day cycle finishes up. That will tell us a great deal about this market and about whether the S&P 500 pattern is about to take off on the upside.

VOLATILE FUNDAMENTALS: I'm going to my favorite truism: "At this stage of the game, there can be no stability. The US, with its towering debts in all sectors of the economy from consumer to corporation to city to state and federal, must inflate or die!" I've seen all kinds of estimates from all kinds of authorities regarding the size of the total US debt. The best estimate I've seen is roughly $5 trillion in visible or obvious debt but there are other trillions in hidden debts and unfunded debts.

No one knows what the average rate of interest is on this mountain of debt, but my guess is that it's upward of 8% (the current 91-day bill rate). Today, few institutions stand ready to buy long-term debt (maturities over say 10 years), so more and more the massive debt of the US is being financed and rolled over in the shorter-term markets.

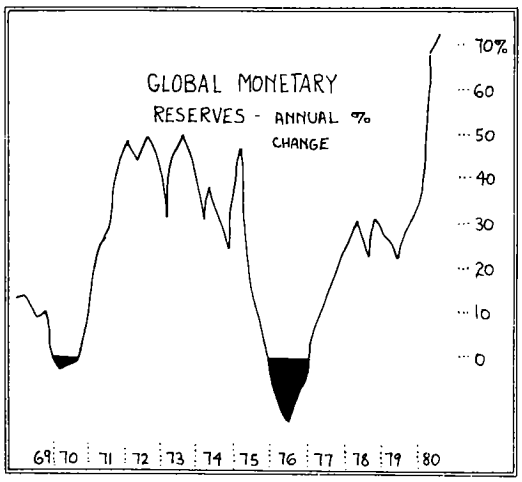
If there is a hidden weakness, if there's an Achilles' heel in the US economy, I'm convinced it is the debt. The enormous debt I've alluded to MUST BE SERVICED. This debt is compounding at high rates of interest even as you read this sentence. And since the debt is so large and constantly growing (compounding). it requires an almost exponential rise in cash flow and GNP to service this debt. That is why I say the US must "inflate or die." So far, rising cash flow and rising inflation have tended to keep the debt floating. But let business lapse into a sustained period of stag-flation, let the recession get out of hand on the downside, and the debt monster will bring on a state of illiquidity and bankruptcy such as has never been seen in this nation.

As I explained, there would be no danger if this were 1950 or 1940, at which times the debts were low. But with today's unbelievable level of debt, this economy can NOT REST for long, nor can it decline for long–without bringing down the whole structure as the cost of servicing the debts literally swallows all profits and throws segment upon segment of the economy into insolvency.

A few of my analyst friends have talked about the possibility of a Fed "mistake" that could pull the economy to its knees. The mistake would act to pull the floor out from under the inflationary spiral. Was the Fed's tightening of credits during January through May the big mistake? Probably not. At any rate, we can't know now. But we do know that the economy started to unravel during May and June, at which point the Fed did a total about face.

The polls now tell us that the consumer is feeling a bit better, and many report that the momentum of the downturn has eased. But we are also told that the upturn will be sluggish and slow. So we can only watch and wait–and see whether enough steam can be generated in the economic boiler to keep the debts floating.

Meanwhile, another amazing phenomenon has surfaced. This is the great rise in world central bank reserves. Central bank reserves are composed of basically gold and foreign exchange holdings (plus SDR's and the reserve position in the IMF). This year, for the first time in modern history, gold makes up better than 50% of world monetary reserves. How did that happen? It was caused by the huge rise in the price of gold.



This chart (courtesy of Int'l Moneylines, 25 Broad St., NYC 10004) shows the year-to-year percentage change in world monetary reserves. At present, the increase is running better than 70% over last year! As a rule, increases in monetary reserves are translated into inflation in a matter of 18 to 24 months, so the chart is telling us that the turnup (which began in mid-1979) could be translated into inflation during 1981 and thereafter.

How does this "translation" work? The central banks suddenly find themselves "way up" as far as total monetary reserves are concerned (at least those who hold gold do). When a nation's reserves boom, it feels good, it feels richer. And it is very likely to print more paper money against its swelling reserves. This process, of course, is inflationary.

Thus, we see the two sides of the inflation-deflation equasion. The world's huge debt is potentially deflationary. Yet the rise in world reserves is potentially inflationary. Which side will win? Will world inflation or world deflation take over? No one has the answer to that one. No one knows if "a mistake" will occur. But there is one thing I am convinced of. Under present conditions, **stability is impossible.**

NOTES & QUOTES: Despite widespread predictions of a "V-shaped bottom," this recession promises to be sticky and slow to turn around. One reason is the adverse position of the American consumer. Still loaded with debt and trying to get out from under, the consumer is not about to be a big buyer any time soon. With inflation still high and unemployment rising, the consumer's real earnings are suffering. Over the last year the consumer has lost 7.7% in real wages (wages minus inflation).

US auto sales remain in the sick ward. Estimates are now that the US auto industry may lose $3.5 billion for the year. GM, without a loss in a decade, posted a quarterly loss of $412 million, worst in its 72 years.

* *

The Wall Street Journal continues to present the best editorial page comments of any newspaper in the nation. Paul Roberts, in a brilliant piece (page 20) on the July 24 WSJ winds up his article on "US Foreign Role" as follows:

> Many nations have been unnerved by the administration's repudiation of American action based on power and by its willingness to accommodate world power changes. They are beginning to perceive the Soviets as the winner in the East-West conflict and are maneuvering toward a deal while they still have a bargaining position.
>
> If Mr. Carter is re-elected, the outside world might interpret it as a sign that the American people don't know or don't care about the deterioration in the geopolitical position of the West. That could set off a stampede toward a catastrophic realignment of world politics. Our friends might see no other choices than to make their money on the decline of the dollar and the rise in gold and to seek accommodation with the Soviets in order to guarantee their oil supplies.
>
> Many of the European and Japanese leaders with whom I spoke were uneasy about the prospect of a Reagan presidency. Nevertheless, they believe that the question is restoration or accommodation and that without American leadership there is no prospect of the former. Any demonstration of the seriousness of American purpose, they said, requires a new administration. And Reagan for sure would turn his back to those intellectuals who denigrate American power. With that one thought to comfort them, they are waiting for November.

* *

The American Economic Council seminar in Beverly Hills, August 7-10 will be a very enjoyable one for me, because I will see so many good friends there. Speakers will include, among others, Howard Ruff, Jim Dines, Dr. Franz Pick, Julian Snyder, Bob Bleiberg, Jim Sinclair, R.E.McMasters, Walt Bressert, Bert Ramirez, Tony Boeckh, and on and on. I'll be speaking too. For info, call (213) 550-6394. I repeat, the above is only a fractional list of the speakers at this amazing conference.

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From our "BETTER LATE THAN NEVER" department: (courtesy of Christian Science Monitor).

Washington

For the first time in half a decade, the pell-mell transfer of high technology US industrial equipment to the Soviet Union – running at $180 to $200 million annually – is showing a sharp drop.

Analysts here cannot yet fully gauge what the final tally will be on technology transfers to the Soviets for 1980. But it is now assumed that the large-scale movement of US industrial products – ranging from sophisticated computers to entire plants and assembly operations – will slow significantly this year.

Factors explaining the downturn range from US reaction to the Soviet invasion of Afghanistan to mounting opposition from Republican political contenders eager to exploit what they perceive as a vulnerable spot in President Carter's foreign policy.

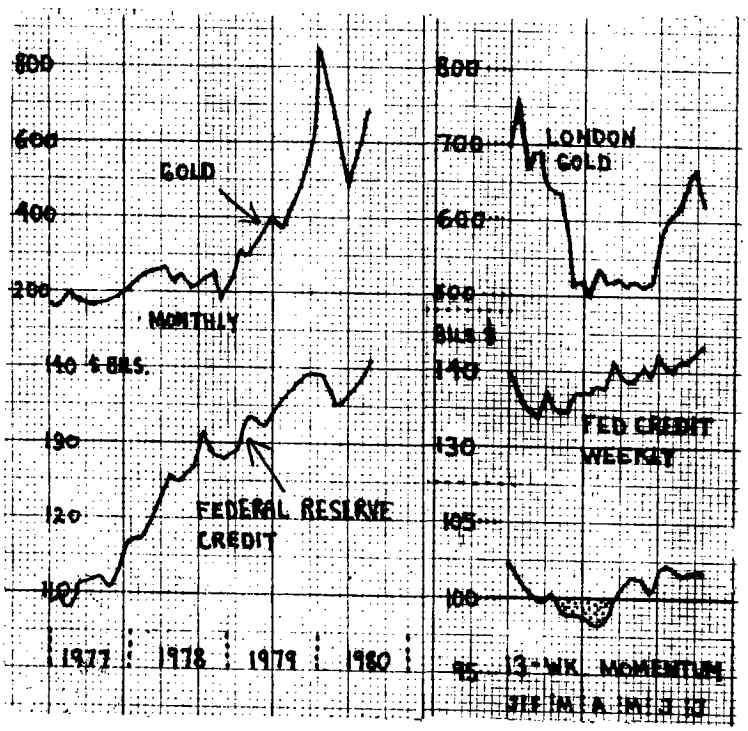
GOLD AND FED PUMPING: I've studied any number of correlations between gold and the fundamental statistics. Two of the best are gold and the rate of inflation and gold and the direction of Federal Reserve Credit. Obviously, no indicator is going to provide a perfect correlation but these two are good.

Perhaps the more fundamental indicator at this time is Fed Credit. Fed Credit is basically the total of all the assets held by the Federal Reserve Board; and the largest percentage of those assets by far consists of T-bills. When the Fed buys T-bills, Fed Credit rises and at the same time cash balances in the commercial banking system expand. This expansion lays the base for more and easier borrowing which generally fires up business and that (unfortunately) has a tendency to increase inflation. (Note: rising business has not always produced increased inflation, but rising business and inflation seems to be an ingrained disease of the current era).

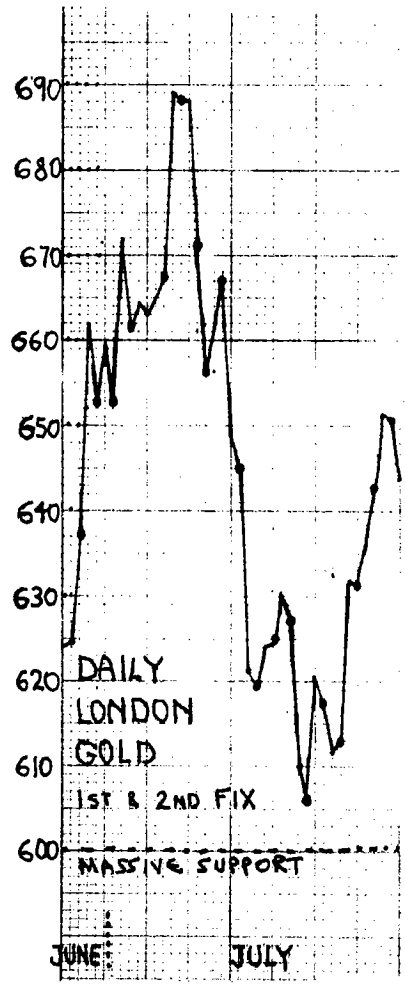
I show a two-section chart. The first traces *monthly* Fed Credit and the monthly price of gold. The correlation, although not exact, is impressive enough.

The other section shows *weekly* Fed Credit plus the 13-week momentum (i.e., 13-week rate of change of Fed Credit). Note that during the period from January to early-April the momentum was heading down. During this period gold experienced a major and violent correction, but gold did manage to hold slightly better than half of its 1976 to 1980 gain.

As you can see on the chart, Fed Credit momentum turned up in April and at this writing Fed Credit momentum is 103.4%. This means that over a 13-week span, the total of Fed Credit is up about 3.4%. This is at the rate of almost 14% a year, a healthy rate of increase and enough to put upside pressure on gold.



GOLD: "There is no fever like gold fever." And there are no opinions like the opinions of gold-followers. I've been following gold since the 1950's. I believe that I was the first of today's active market letter writers to recommend gold shares (August, 1960). Of course it was illegal to own gold bullion during the 1960's. I read most of what is written today about gold, and I know most of the leading gold writers.



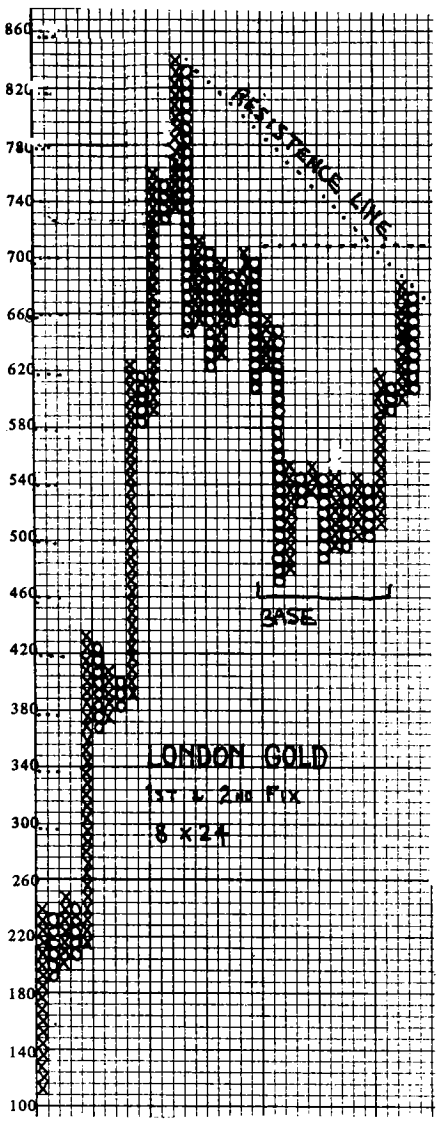
Nobody is right all the time regarding gold, but probably the best advice has been given by analysts such as James Dines, C.V. Myers, L.T. Patterson, Jim McKeever, who are advocates of holding a certain portion of assets in gold and gold shares until hell freezes over (or until the dollar fizzles out). I have always advocated a position in coins (15% the average), and so, I believe, has Harry Schultz.

In his current (July 14) report Harry states, "*Speaking of gold, I forecast in my speech in Holland that gold will go to $1200 within 8-11 months. That will be based mostly on shortage of supply and increased demand, spiked by renewed inflation. I also forecast that as the Soviet threat to the West is better realized, panic buying will take over and the price will move to $3000 within 2 years. This presumes no major technological breakthrough by the West and no breakdown within the USSR.*" (Schultz, Xebex, PO Box 134, Princeton, NJ 08540).

Julian Snyder, another excellent analyst, notes in his latest July issue (Int'l Moneyline, 25 Broad St. NYC 10004), "*We still consider gold an intermediate term trading situation with 620-640 basis December a downside possibility, and 720 the upside potential. . . . As far as the long-term outlook is concerned, IML readers will see the price of gold in 'old dollars' – present day money– go to $5000 an ounce by the end of the decade and $10,000 an ounce in a shorter time after that. I don't believe that gold will buy much more then than it does now, but paper money will buy much less. From now on, gold will tend to counterpoint the depreciation in the currencies.*"

GOLD ACTION: From the March 8 low of 474 to the early-July high of 688 gold gained 214 points. The halfway (50%) level of that rise is 581. The most recent late-July correction took gold down to a London fix low of 606 on July 17, 25 points above 581. Thus, on this corrective test gold held well **above** the 50% level of the previous advance, and this is a bullish technical point for gold.

I stated in the last Letter (787) that I believed gold was working on the right shoulder of a very large head-and-shoulders **bottom** pattern. "If that is the case," I continued, "then (spot) gold should hold above the 580 level, and ideally above the 600 level."

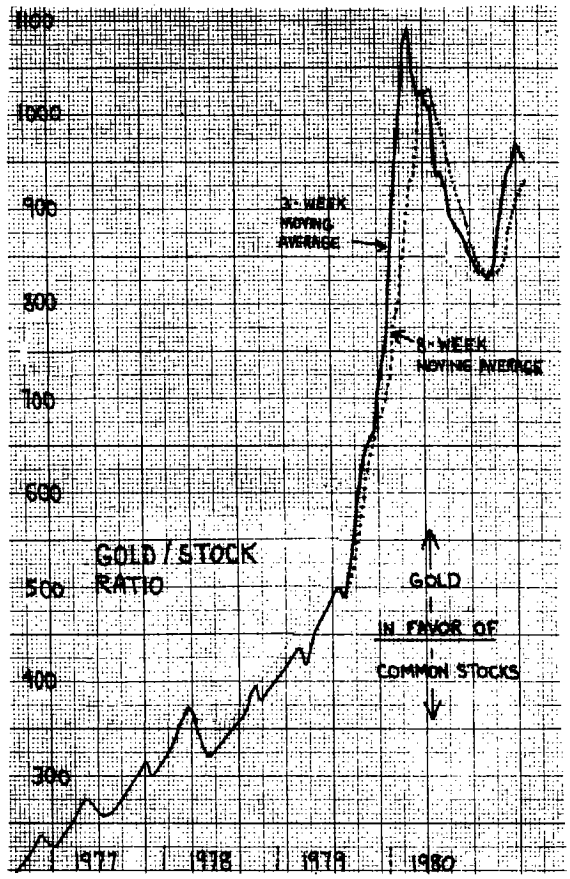


So far, this is exactly what happened. The accompanying chart shows the most recent action in detail, since it is a daily chart of the first and the second London fix. Let's follow the action. Gold corrected from the 688 level, and the correction was rapid and sharp. The metal fell below the 620 level but held below 620 for only 3 trading days. On July 17 gold broke below the 610 level (to 606) but held there for only 1 trading day! On July 23 gold rallied above the 630 level, and by July 25 gold had advanced to above 650. The action has been fast and calculated to produce losses for traders. Two things seem clear. (1) A new base has been built just above 600, and (2) large orders to purchase gold are in place at the 600 to 610 level. Conclusion: on any forthcoming pullbacks or news scares, gold is a buy, particularly if it gets near the 600 level again.

What next for gold? I would like to see gold fluctuate in a trading range between 606 and 688–and the longer the better. Why? Because the longer gold fluctuates between 600 and 688, the larger and more impressive the "right shoulder" of the current "head-and-shoulders" (see point & figure chart). The Olympics are near over, and it is possible that gold could respond to some news event. A releasing of the Iran hostages could send gold temporarily lower, and a Russian move into the Mid-East could send gold sharply higher. Overall, I feel gold is now taking the measure of the dollar, deficits and inflation, and the outlook is not entirely clear–yet.

The primary trend is bullish for gold and gold shares. On the upside, the first bull target for gold is again the 662 level, a level which was discussed at length in the last few Letters (662 is the halfway level of the entire 1980 drop from 850 to 474). The next target, after 662, would be the 688 July high, and after that the 700 resistance level. The 700 level, as I noted in Letter 787, is the last line (trendline) of resistance. Closing above 700, gold would be in line for an attack on the all-time high of 850.

I again want to repeat that gold is in the early, formative stages of the third and final stage of the great bull market that began in 1970-71. Bull markets are tricky, deceptive and hard to follow. Gold's "job" is to get above the old 850 high again–with as little speculative following as possible. So far, it's doing pretty well.



The exponential moving averages for gold are all bullishly intact. The 5-week MA is now at 633, the 13-week MA is at 604, and the primary or 50-week MA is at a new all-time high of 513. Gold's momentum (13-week rate of change) was 124, which means that gold last week was $24 above its price of 13 weeks ago. The peak of momentum was hit on the weeks ending July 10 with momentum at 133.

GOLD/STOCK RATIO: This is the all-important ratio of gold to common stocks (bullion divided by the NYSE Composite). With the recent correction in gold and strength in the stock market, the 3-week MA of the ratio came down, but it has not yet crossed below the 8-week MA (see chart above). Thus, no new signal was given to suggest that strength was building in common stocks as compared with gold. Late last week the stock market weakened as gold turned higher, and if this continues the 3-week ratio will shortly turn higher in favor of gold again. But I don't try to out-guess this indicator–I just follow it, and it still says, "The profits are in gold."

LATE NOTES: The stock market ended the week (July 25) with the PTI at 1268, down 18 points from the 1284 peak of July 21 and 22. Three down days don't signal the 'end," and the important question now is whether the PTI enters a **persistent** decline and how the PTI looks during any forthcoming rallies. The Fed is doing its thing (pumping), and the discount rate was dropped a full 1% (to 10%) on July 25. A technically strong market would be bulled by this kind of news–so let's watch.

With the Shad dead, Iran may have a face-saving way of releasing the hostages. If they do, gold could sell off on a temporary "clearing of the international air" basis. If this occurs, this will provide an opportune "buy spot" for gold.

NEXT MAILING: I'll be at the American Economic Council Seminar during August 7 - 10. For this reason, the next Letter *may* be mailed one day late, on August 14 rather than the 13th.